

**Walker Review of Corporate  
Governance of UK Banking Industry**

**Norton Rose Response**

**19 June 2009**

## **Response to Walker Review of Corporate Governance of UK Banking Industry**

### **1 Introduction**

- 1.1 This is Norton Rose's response to the Walker Review of Corporate Governance of the UK banking industry (**the Walker Review**). Norton Rose has extensive experience in the financial services sector and, more generally, in advising boards of large corporate and financial institutions on their legal and regulatory duties as directors. We offer our views (on the basis of such experience) in the following areas:
- 1.1.1 Whether an additional duty should be imposed on directors to identify and control systemic risk;
  - 1.1.2 the balance of skills, experience and independence required on the boards of UK financial institutions;
  - 1.1.3 the mitigation of risks facing directors;
  - 1.1.4 the role of institutional shareholders in engaging effectively with companies and monitoring boards; and
  - 1.1.5 the level of engagement between non-executive directors (**NEDs**) and the regulator.
- 1.2 We do not consider that it is appropriate or necessary to add a further statutory duty for directors of banks and financial institutions (**BOFIs**) to identify and address systemic risk. We consider that this is a role for the industry's regulators since it is regulators who are in the best position to have a macro view of the entire industry, and are without the inherent conflict that such a duty would give to directors required to act in the best interests of their company's shareholders. In our view, reform should address the need to encourage the development of talent and experience in the board room and that this can be done with some adjustment and refocus of existing tools and measures.

### **2 The imposition of an additional duty on BOFI directors to deal with systemic risk**

- 2.1 We do not believe that there should be an additional duty on BOFI directors to identify and address the systemic risk posed by a BOFI (i.e. the risk posed to the wider financial system or the economy). This role should be for the consideration of, and is best undertaken by, the regulator.
- 2.2 Directors can only assess their own company's infrastructure and the risks relating to it; only a regulator is in a position to assess the implications of certain risks on the financial system at large. In addition, directors' duties are owed to shareholders which, as can be seen in the following scenarios, can conflict with a duty to have regard to systemic risk:
- 2.2.1 In the case of a takeover or acquisition where shareholders are being offered cash and the terms of the offer are in the best interests of shareholders (i.e. they will receive the best available price for their shares), it would be extremely difficult for the directors not to recommend the transaction even if, for example, it did not accord with the long term success of the company or the wider interests of the financial industry sector. Directors are evidently not in a position to analyse and address the wider systemic risk posed by such a transaction where their primary objective is to act in the best interests of shareholders generally.

- 2.2.2 In the case of any major transaction, shareholders consider the risks and potential benefits associated with it and then vote on the proposal submitted by the board. As approval rests with the shareholders, the directors' duty of care is overlaid by the duty of disclosure to the shareholders, not the outcome of the actual transaction. In such a case, it is unclear what benefit (if any) would arise from changing the underlying statutory duties of directors set out in the Companies Act 2006 (CA2006). Directors can only be liable for non-disclosure and other particular obligations imposed on them under the disclosure regimes.
- 2.3 In our view, it **is** the board's responsibility under the CA2006 to decide on the appropriateness of a BOFI's business model, (i) having regard to the long-term success of the company and (ii) within the accepted regulatory parameters that the BOFI operates under. It should **not** be the responsibility of the board to identify the potential flaws in a BOFI's business model that could have wider systemic consequences; this duty should fall on the regulator and/or the rating agencies, which are in a position to monitor and deal with systemic issues. The regulator may then take such action it sees fit, such as liaising with the board to ensure appropriate action is taken to address such systemic issues. Changing the duties of directors such that a director of a BOFI would be in breach if they failed to take into account the systemic consequences of the business model would impose an exceptionally high standard of care on directors of BOFIs.
- 2.4 Clearly the failure of a major BOFI can have serious consequences for the economy (through the knock-on effect to depositors, other BOFIs and businesses) which is why BOFIs operate within such an extensive external regulatory regime and why monitoring systemic risk in BOFIs should be a key role for regulators. This in itself provides a strong argument why the regulator, rather than the directors of BOFIs, are better placed to oversee and control systemic risk.
- 2.5 On a micro level, there is always the risk of failure of the internal systems and controls within a BOFI and a failure of the executive and management to appreciate a material risk. Failure at this level is not simply a question of more intensive regulation but highlights the extent to which directors need to understand and implement systems and controls within a BOFI. For example, directors need to understand that the delegation of any work requires them to play a continuing active role, and ensure the suitability and competence of those to whom tasks are delegated. We acknowledge that the internal systems and controls within BOFIs cannot be expected to be infallible; there will always be innocent and calculated instances when they are breached, and some companies may fail as a result. However, the systems and controls must be robust enough for any such failure to be contained, and not become systemic.
- 2.6 Some have made the case that directors of a BOFI should understand and be accountable for the whole catalogue of products and services that their company provides. We believe that it is impossible, in particular for NEDs, to understand all the complex business within a BOFI that could, at any moment, lead to an unforeseen loss and potentially place the institution and/or wider market at risk. What they can and should do is ensure that they are satisfied by the quality of the risk management controls within the organisation. This can be achieved by making sure that (i) the proper systems are in place to monitor all products and services, (ii) appropriate committees such as risk or audit committees are in place and staffed with competent and accountable people with the requisite expertise to understand the products and services and the risks they pose, and (iii) all material risks are understood by the directors and that they can act appropriately.

### **3 The balance of skills, experience and independence required on the boards of UK banking institutions**

- 3.1 While we do not believe that the statutory duties set out in the CA2006 duties should be expanded for directors of BOFIs, boards of BOFIs must ensure the competence and

quality of the individual directors executing such duties. In particular, it is essential that BOFIs have highly competent and skilled individuals undertaking the role of the NED.

- 3.2 It should be an overriding duty of a NED to challenge constructively the executive directors; to be proactive in questioning board proposals and engage in discussions regarding strategy, policy and transactions. Consequently, we believe that it is extremely important for NEDs to have the appropriate industry experience and the credibility to enable them to fulfil this role effectively. NEDs who have financial services experience will have a better understanding of the BOFI's business, while being one step removed from day to day management, which puts them in an ideal position to analyse, assess and question the business strategy. It is also desirable, to the extent that resourcing allows, to counter the risk of NEDs feeling isolated in respect of raising issues with the executive, and more consideration should be made to encourage NEDs to be supportive of one another.
- 3.3 To encourage this culture of challenge within BOFIs, it is important that NEDs are given the appropriate support. For example, by strengthening the role of the secretariat supporting NEDs and ensuring that they are impartial and do not simply work for the Chief Executive's office. NEDs should also be encouraged to seek independent advice on issues relating to capital/risk and on corporate transactions. This practice is already established to some extent on large corporate transactions, with an increasing number of NEDs seeking independent advice from independent financial advisers.
- 3.4 It is not just the NEDs that need to be strengthened: where the circumstances demand it, the quality and experience of the whole board will need to be of a sufficient standard, and the regulator can take an active role here too. The regulator could get more involved in making sure that boards have the commensurate mix of experience, experts and generalists to deal with the sector they operate in.
- 3.5 We acknowledge that there is a clear resourcing problem in finding appropriate individuals who have the relevant expertise but who are not conflicted through positions at certain BOFIs. It is extremely important, therefore, that the available pool of talent is not limited further by individuals being deterred from taking up NED positions within BOFIs as a result of the risks that they face (see paragraph 4 below). One way of expanding the pool of talent that BOFIs can draw on may be to relax the requirements for independence of directors, so that there are fewer obstacles to BOFIs retaining experienced former executives from their own institution to take up roles as NEDs. This is a more realistic solution to the issue of bolstering the competence and experience of the NEDs than expecting BOFIs to take on NEDs who have held long-term executive roles at rival institutions.

## **4 Mitigating the risks that directors face**

- 4.1 The statutory duties of directors set out in the CA2006 apply equally to NEDs and executive directors (although the particular knowledge and experience of individual directors is taken into account in determining whether that director has acted with due care and skill). Consequently, NEDs on the boards of BOFIs are subject to the same legal liabilities as executive directors who control the day to day management of the BOFI. If NEDs are to be attracted to the boards of UK BOFIs, then they will want to be afforded some protection against the liabilities which arise as a result of them discharging that office.
- 4.2 Statutory immunity for directors of BOFIs is clearly not an option. The aim should not be to remove *all* risk of challenge; just as NEDs should be encouraged to challenge the executive, a board can only prosper in an environment where its decisions may be scrutinised.
- 4.3 Prudent directors, whether or not they believe themselves to be protected by indemnities or insurance, will take every reasonable step to prevent liability arising. In practice, directors should be able to mitigate most risks by, for example, seeking independent

advice (where required), holding regular board and other management meetings and reviews and keeping clear contemporaneous notes of meetings and any difficulties encountered as evidence of the steps the directors took, and why.

- 4.4 When things do go wrong, however, directors seek protection through indemnities and D&O insurance policies. These are designed to protect directors from personal losses which may result from claims made against them in relation to the discharge of their duties as directors. In our view, the personal liability faced by directors is not generally mitigated by D&O insurance policies. First, claims may fall down at the ‘first hurdle’ and fail in the small print of the policy and, secondly, even if the directors are insured against ultimate liability, few insurance policies provide cover for the actual cost of the legal proceedings which can escalate, in some cases, to millions of pounds. The defence costs for legal proceedings can and should be addressed by an indemnity from the BOFI to its directors.
- 4.5 Ultimately where legal proceedings taken against an individual director are successful, the financial liability of that director can be grossly disproportionate to the fees that he was awarded for undertaking the role on the board. In our view, liability should be capped so that it is proportionate, for example to the individual director’s fees or in some other manner. Until this issue is resolved satisfactorily with a better risk / reward balance, talented candidates may be discouraged from taking up influential posts at large BOFIs if their personal assets may be at risk.

## **5 The role of institutional shareholders in engaging effectively with companies and monitoring boards**

- 5.1 Institutional shareholders cannot and should not be expected to act as surrogate regulators; this potentially brings them into direct conflict with their duties to their beneficiaries. In the event of an institutional shareholder becoming aware of a risky strategy or business decision by a company, they would act in the interests of their beneficiaries and if appropriate sell their stock. On a related note, the market cannot place reliance on major shareholders of BOFIs to demonstrate prudence to prevent systemic risk; they are interested in maximising profit which directly correlates to increasing risk.
- 5.2 However, shareholders do have the ability to influence the appointment of the board and directors’ remuneration through their approval at the Annual General Meeting (**AGM**) and can ultimately hold boards to account for their actions by exercising their right to remove directors from the board where they make detrimental decisions. Whether shareholders utilise this power adequately is questionable; in the aftermath of the current credit crisis, shareholders have generally not removed directors of BOFIs. Ultimately, it is unlikely that institutional shareholders will try and veto a decision by the BOFI that they think will put their investment at risk, they will instead usually exit by selling their stock. Their only alternative is to ‘stay put’ and vote down the directors at the next AGM which, whilst morally commendable, will not address the loss in value to their investment.
- 5.3 *Concert parties and shareholder activism*
- 5.3.1 Where shareholders come together in respect of a board control-seeking proposal, they may, depending on the size of their combined holdings, trigger the requirement to make a mandatory offer under Rule 9 of the Takeover Code where a member of the group acquires a further interest in shares.
- 5.3.2 We acknowledge that a blanket application of a safe-harbour for this issue would not be appropriate as there are times when it is important for concert action by shareholders, including funds, to trigger a mandatory offer under the Takeover Code. However, it would be helpful if the Takeover Panel clarifies this area so that institutional shareholders (and in particular funds) are not under a misapprehension as to whether

or not they can join like-minded shareholders in holding boards to account. As always with the Takeover Panel, early consultation for guidance on a particular issue is key, but it remains to be seen how many funds will take this step on their own accord.

## **6 NEDs' engagement with the regulator**

- 6.1 Acting as a NED for a regulated firm is a controlled function and any individual who wishes to perform such a function has to be approved by the Financial Services Authority (**FSA**) before doing so. The FSA considers that the duties of an NED are not limited to the interests of the shareholders but can be owed to other stakeholders as well, provided that such stakeholders have a direct link to the relevant company. For example, the FSA considers that the NEDs of firms that provide services and products to retail clients must consider the interests of those clients.
- 6.2 The existing regulatory framework for approved persons could be used to draw NEDs' attention to behaviour that fails to meet an appropriate regulatory standard. The Code of Practice for Approved Persons (**the Code**), in particular the sections supporting the significant influence functions<sup>1</sup>, could be expanded to include additional evidential provisions that describe sub-standard types of behaviour. Alternatively, the FSA could expand the Code by creating a section that focussed specifically on the role of NEDs.
- 6.3 We acknowledge that going to the regulator can be extremely damaging for the NEDs' relationship with the executive and, in most cases, is only considered as a last resort. However, we believe that NEDs should be encouraged to engage more with the regulator; increased dialogue between the regulator and the NEDs, for example, would equip NEDs with a greater awareness of risk. It is essential, therefore, to remove the belief that going to the regulator is an admission of failure and NEDs should be encouraged to approach them without fear of censure.
- 6.4 There is therefore a role for more active dialogue between the FSA and NEDs. The FSA should consider establishing regular formal forums for the NEDs of authorised firms. This would give the FSA the opportunity to brief NEDs on current regulatory issues both at macro and micro level. This might take the form of an annual conference and could be organised on a self-funding basis.
- 6.5 In addition to regular industry-wide events for NEDs, the FSA should develop firm specific contacts with NEDs. These arrangements could be formal and regular, say annual or semi-annual meetings, but also include more ad hoc and informal contact. Such contact should be made outside the framework of the FSA's ARROW reviews and adopt a collaborative agenda.
- 6.6 The FSA should also consider developing other of its existing regulatory 'tools'. For example, the existing concept of 'Dear CEO' letters could be adapted to service NEDs. 'Dear NED' letters could inform NEDs of current FSA concerns and be used to alert NEDs to systemic industry wide concerns.

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<sup>1</sup> Statement of Principle 5 - An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function is organised so that it can be controlled effectively.

Statement of Principle 6 - An approved person performing a significant influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.

Statement of Principle 7 - An approved person performing a significant influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant requirements and standards of the regulatory system.